# Opportunity ZONES UPDATE

Opportunity Zones have generated quite a bit of interest lately, due to their tax benefits. Below is a quick summary of how the program works:

> Investors must contribute capital gains into a Qualified Opportunity Fund (QOF) within 180 days of realizing that gain. If the capital gains are generated from a pass-through entity and passed to an individual investor, the individual must invest that gain within 180 days of the entity's year-end.

> Tax on the original gain is deferred until the earlier of a sale or exchange of the investment, or December 31, 2026.

> If the interest in the QOF is held for more than five years prior to 2026, the taxable portion of the original gain is reduced by 5%. If it's held for seven years prior to 2026, the taxable portion is reduced by an additional 5%, for a total of 10%.

> If the interest in the QOF is held for at least ten years, any applicable appreciation over the original gain is not taxable.

On April 17, 2019, the IRS released its second round of proposed regulations on Opportunity Zones. The regulations provide additional guidance on how the Opportunity Zone provisions will work in practice. Below are some updates from the proposed regulations as they pertain to real estate.

## CAPITAL GAINS FROM THE SALE OF 1231 ASSETS

Gains on the sale of depreciable property used in a trade or business (section 1231 property, like residential rentals) have a unique netting process. 1231 gains are netted with 1231 losses, and if the taxpayer ends up with a net gain, the gain is a capital gain, whereas net losses are ordinary losses. Because this netting process occurs on the taxpayer's tax return, the proposed regulations state that the 180-day capital gain reinvestment period won't start until the last day of the taxpayer's tax year.

## LEASED PROPERTY

The recent proposed regulations allow both a QOF and a QOZB to categorize leased property as Qualified Opportunity Zone Property and include leased property in its asset test. There is no original use or substantial improvement requirement if leased from an unrelated party. If leased from a related party (20% test), the property must meet the original use requirement, or the QOF or QOZB must acquire additional qualifying property of at least equal value to the leased property. This is similar to the substantial improvement requirement, but the lease itself doesn't need to be substantially improved.

## FURTHER GUIDANCE ON ORIGINAL USE

QOFs and Qualified Opportunity Zone Businesses (QOZBs) must invest in qualifying property. Qualifying purchased property must meet either an *original use* requirement or a *substantial improvement* requirement. The new regulations stipulate that the original use begins on the date any person first places the property in service within the Qualified Opportunity Zone. Acquisitions of development projects that are incomplete, and therefore not yet in service, would qualify as *original use*. The regulations also specify that property that is unused or vacant for at least five consecutive years will qualify as *original use*.

## REINVESTMENT

QOFs may shift between different investments in Qualified Opportunity Zone Property or Qualified Opportunity Zone business interests. Historically, it's been unclear how shifting between investments would impact the asset requirements and semiannual testing requirements. According to the proposed regulations, the entity will be exempt from the asset testing requirement if the sale proceeds of QOZP are held in cash, cash equivalents, or debt instruments (with a term no longer than 18 months) and are subsequently reinvested into other QOZP within one year.

## SELLING A QOF AFTER 10 YEARS

If investors sell their equity interest in the QOF after holding for ten years, the gain is generally excluded. However, investors don't have to sell their equity interest in the QOF; the QOF can sell the underlying assets and pass the gains to investors, who wouldn't need to recognize any capital gain. It's important to note that this rule currently applies to QOFs that own qualifying property directly, rather than through a QOZB.

In the real estate world, buyers generally want to buy assets rather than an equity interest, so this is a relief to real estate investors. However, not all of the gain may be excluded if it's an asset sale with gains passed out to investors. In this scenario, only capital gain is excluded from taxation. Depreciation recapture is not excluded from taxation. There is indeed a downside to selling assets rather than equity interest in a QOF.

## PRACTICAL APPLICATION POINTS – *SO WHAT DOES ALL OF THIS MEAN FOR YOU?*

- Capital gains that likely need to be invested by the end of June 2019:
  - 2018 capital gains from pass-through entities (*e.g.* partnerships, S-corporations, etc.)
  - 2018 section 1231 gains from pass-through entities
  - 2018 section 1231 gains generated individually, not from a pass-through (*e.g.* a residential rental held directly by the individual taxpayer
- Investing in a QOF before the end of 2019 provides the biggest reduction of your original gain.
- If you're considering a sale of an asset that would result in a gain, talk to your tax advisor first! Timing is important if you're considering investing the gains in a QOF.
- If you haven't yet filed your 2018 tax return, talk to your tax advisor as soon as possible. You may discover capital gains that could qualify for this program.

Opportunity Zones offer many potential benefits to real estate investors. Our Opportunity Zone team is prepared and eager to help you navigate the rules.

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